Feature

Key 2020 Corporate Governance Developments Affecting Health Care Boards

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The pandemic notwithstanding, the year 2020 is notable for the number of significant corporate governance developments relevant to health industry companies. These developments include matters of board engagement, compliance oversight, workforce culture, the indicia of diversity, conflicts of interest, regulatory enforcement, and other matters.

Individually and collectively, these developments reflect increasingly more sophisticated expectations of the governing board by stakeholders, regulators, commentators, and third-party interest groups. As such, they are appropriate topics for board education, and more particularly, for consideration in strategic governance planning by the board.

Board Engagement

Main Theme: Substantially more focus has been placed upon the ability of directors to commit appropriate time and energy to their fiduciary duties.

The impact of the pandemic, together with the increasing responsibilities associated with board service on a corporation operating in a highly regulated environment, have contributed substantially to this focus on engagement.

For example, the incipiency of the pandemic raised substantial questions as to whether the extent of director engagement is to be materially increased during times of extraordinary crisis. The general expectation is that COVID-19 and other events of extraordinary volatility require complete board ownership, beyond that associated with basic enterprise risk oversight.[1] Yet, many health care boards preferred to adopt a less aggressive posture, opting to exercise careful deference to senior management and its expertise—without appreciable pushback from stakeholders or regulators.

Increased expectations of director performance also prompted mainstream interest in the governance practices of (1) director "offboarding" (i.e., a focused board process to achieve a structured separation from certain directors without prompting controversy or ill will); (2) director "onboarding," (i.e., focused educational, training, and cultural measures to prepare an incoming director for board service); and (3) director "overboarding" (i.e., addressing circumstances where director service on multiple boards potentially limits their effectiveness).[2]

Efforts to "reopen" the economy after government-imposed lockdowns provided a reminder of the board's lesser-known fiduciary responsibility to monitor management's post-crisis business resiliency efforts. The concept of business resiliency refers to broad concepts that focus on long-term business and cultural resiliency from truly catastrophic or abrupt disruptions of cross-industry, national, or global proportions.[3] Those monitoring efforts could also extent to management proposals to reorient the corporate business model to reflect key lessons learned from the pandemic.

Issues of director attentiveness (and possibly oversight of quality of care) were presented in two distinctly different developments. First was a major shareholder derivative suit alleging that the officers and directors of an international aerospace manufacturer breached their fiduciary duties by dismantling the company's safety-grounded corporate culture in favor of a financial engineering focused culture.[4] This alleged conduct supposedly led the board to miss numerous safety-related red flags in new product development and contributed to the death of hundreds of passengers.

The second was the pursuit of criminal charges against a former food industry CEO arising from what the government alleged was his effort to deceive certain

company customers by removing contaminated products from stores without revealing the full details of a listeria outbreak at a company plant.[5] The government's action served to remind senior executives of the regulatory risks associated with communications during times of corporate crisis, especially communications with public health and safety implications.

Compliance Oversight

Main Theme: Expectations of board oversight of the compliance program, and particular manifestations of that oversight, have increased.

A major 2020 development was the June 1 release from the Department of Justice (DOJ) of updated guidance on the Evaluation of Corporate Compliance Programs.[6] The new release set forth a series of factors for DOJ attorneys to consider when assessing the effectiveness of corporate compliance programs as part of making charging decisions and negotiating resolutions. In that regard, the updated guidelines provide a useful resource to the board and its audit & compliance committee.

Of particular relevance to the board and its audit committee is DOJ's renewed emphasis on the substance and adequacy of resources made available to the compliance program and how those factors relate to the determination of compliance program effectiveness. The revised guidelines also call for a clear articulation of the rationale for, and evolution of, the compliance program; why the program was established in the way it was, and why and how the compliance program has evolved over time.

Another major development was the continued willingness of the Delaware courts to allow a breach of duty action to proceed based on allegations that the board was indifferent to its obligation to exercise oversight of the company's compliance with positive law—including regulatory mandates. These cases have been allowed to proceed based upon pleadings indicating that defendant boards failed to recognize the "red flags" of compliance failures, which allegedly led to significant consumer and stakeholder harm.

One such case arose from a pipeline rupture, which spilled several thousands of barrels of oil into an environmentally sensitive area.[7] The primary pleading was based on CEO testimony that the board did not discuss the matter of pipeline integrity, and that while the board did have an audit committee, there were no documents indicating that the committee ever conducted pipeline integrity review.

Another such case arose from material weaknesses in a company's financial statements and a subsequent restatement thereof.[8] The primary pleading was based on allegations that the company's audit committee met sporadically and only when required by securities laws, held abbreviated meetings, frequently acted through consent agenda, and failed to follow up on auditor reports reflecting concerns with the company's financial statements.

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The third such case arose from a federal criminal investigation of a division of a pharmaceutical company for failure to register with the Food and Drug Administration.[9] The primary pleading was based on allegations that an outside law firm report had previously determined that the division was not integrated into the company, and that a former company executive had filed a complaint in federal district court alleging that the division was operating illegally.

The Houston Astros' "Operation Codebreaker" sign stealing scandal provided an extraordinary example of how a sophisticated business organization led by accomplished executives can fail to maintain a framework of ethics and commitment to applicable rules.[10] As one of the most notorious scandals in baseball history, it attracted widespread public attention. Boards across industry sectors may wish to use this example as a means of re-examining the effectiveness of their own obligations to exercise oversight of the organization's commitment to compliance and ethics.

Diversity and Governance

Main Theme: Diversity across the spectrum is becoming a major factor in board and committee composition, and in matters of human capital and talent management.

For example, a new Conference Board report highlights important trends relating to board composition and diversity; the profile and skill sets of directors; and policies on their election, removal, and retirement.[11] Key findings include: (a) almost 14% of boards of large companies do not have a single woman on their board; (b) less than 5% of board chairs are women; (c) the most popular specialized skillsets for board members are finance and information technology; (d) the average age of board members remained unchanged year-over-year (approximately 63); and (e) more than half of surveyed companies do not restrict the number of additional directorships their board members can accept.

From a gender equality perspective, the sixth annual Women in the Workplace study by McKinsey and LeanIn[12] identifies several steps intended to address the potential that one in four women are considering either downshifting their careers or leaving the workforce entirely as a consequence of the pandemic. These

include (1) making the workplace a more sustainable environment, especially for working mothers and senior level women; (2) resetting norms in terms of work options and communicating support for workplace flexibility; (3) assessing performance criteria applied before the pandemic for continued utility; (4) taking measures to minimize gender bias within the organization; (5) adjusting policies and programs to better support employees during COVID-19; and (6) strengthening employee communication regarding the state of the business and key decisions.

A new California law requires publicly held corporations whose principal executive offices are located in the state to satisfy mandated levels of a racially, ethnically, and otherwise diverse board beginning in 2021.[13] Affected companies must ensure that their boards have a minimum of one director from an underrepresented community by the close of the 2021 calendar year. By the close of the 2022 calendar year, the obligation increases in accordance with the size of the board. "Director from an underrepresented community" under the law means an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian or Alaska Native, or who self-identifies as gay, lesbian, bisexual or transgender.

A series of similar diversity-based derivative complaints have been filed against a broad cross section of prominent corporations during the second half of 2020.[14] Key allegations in these suits are that the defendant companies and their boards (a) failed to implement information reporting systems that would have alerted the boards to alleged compliance failures associated with various anti-discrimination laws; (b) made certain statements regarding their commitment to diversity that were "materially false and misleading"; and (c) failed to satisfy what the complaint described as a fiduciary obligation to nominate diverse board candidates and evaluate board composition and performance.

Oversight of Workforce Culture

Main Theme: Board responsibility for monitoring the culture of the organization's workforce was confirmed by a number of significant 2020 developments.

There has been a growing recognition over the last several years that corporate boards have a fiduciary responsibility to exercise oversight of corporate culture. As noted by the National Association of Corporate Directors, this is grounded in the perspective that a positive organizational culture can be a meaningful corporate asset in a variety of ways (e.g., influencing operational performance, talent development, and organizational reputation).

This perspective has been confirmed by a new survey from the consulting firm Accenture, which concludes that seven in ten boards have increased board involvement in workforce strategy in the pandemic.[15] In particular, the survey identified the most discussed topics among directors as productivity, health and safety, and talent development and recruiting. It also concludes that boards that are highly involved in workforce strategy have stronger business performance and innovation and are more prepared for a crisis. Nevertheless, workforce issues requiring additional focus at the board level include pay equity, diversity and inclusion, and workforce reduction plans.

The board's focus on workforce culture was at the core of several developments regarding allegations of personal misconduct of corporate CEOs. For example, the resignation of Liberty University President Jerry Falwell, Jr. was attributed to his frequent deviation from the moral code by which all University constituents are to be held (e.g., modesty of dress, abstinence from alcohol).[16] The ongoing allegations concerning Mr. Falwell's personal conduct were said to have negatively impacted the unique organizational culture of Liberty University.

Highly public allegations of personal misconduct by the now-former CEO of a major food services company suggested the need for boards to revisit the effectiveness of the corporate human resources function, especially as to its ability to process and oversee policies involving harassment and personal relationships with direct reports. It also indirectly suggested the need for a futility-reporting bypass for HR leaders to the board and to legal and compliance departments; and to directing increased engagement by the board committee with responsibility for HR.

Workforce culture oversight issues also presented themselves prominently in the saga involving the COVID-19 outbreak on the aircraft carrier U.S.S. Roosevelt.[17] The Navy's discipline of the ship's Captain for his response to the outbreak reflected a "drive the outcome" organizational culture. This response prompted corporate boards to review their company's own internal culture of openness and transparency, particularly as they relate to expectations of managers to promptly share concerns regarding critical problems, rather than having them first try to fix the problems themselves.

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Conflicts of Interest

Main Theme: A series of state and federal court decisions provide additional guidance on how boards should address individual director conflicts of interest.

For example, a Delaware Supreme Court decision highlighted the need for all parties to an M&A transaction to be alert for potential conflicts of interest that may arise when participants negotiate personal financial arrangements before board-approved agreement is reached on transaction terms.[18]

The case involved a derivative challenge to an $18 billion merger of two large professional and financial services companies, based on allegations that the CEO/Chair of one of the merging parties breached his fiduciary duty by failing to disclose to his board, prior to commencement of negotiations, the existence of post-closing employment discussions with the other merging party. These allegations included that the CEO/Chair was materially interested in the transaction and that his board would have found material to their deliberations the fact that its lead negotiator (the CEO/Chair) had been offered a compensation arrangement before the transaction terms had been finalized.

The Delaware Supreme Court ruled that the allegations were sufficient to rebut the presumption of business judgment rule protection, and to apply the stricter "entire fairness" standard of review to the process.[19]

The timing of the establishment of an internal conflicts review process was at issue in a derivative action arising from breach of duty allegations involving a take-private acquisition of a company.[20] The complaint alleged that the company was sold at an unfairly depressed price and that insiders influenced the transaction to divert consideration to themselves. Although the defendants did not challenge the fact that a majority of the board was conflicted, they argued for dismissal of the claims under the business judgment rule because the transaction was negotiated and approved by a special committee of unconflicted directors.

The court, however, held that "to effectively cleanse a transaction . . . the special committee must be constituted ab initio . . . prior to substantive economic negotiations."[21] The court denied the motion to dismiss because it found that the complaint adequately pleaded the existence of substantive economic negotiations before the special committee was established.

Timing was also an issue in a Delaware Chancery Court decision that examined the limits of recusal as a means for addressing director conflicts of interest.[22] The underlying facts involved a proposed arrangement by which a controlling shareholder sought to increase his holdings in the company. The interested directors recused themselves from the board action to approve the arrangement. The Chancery Court noted that the effective use of recusal requires a director to completely avoid any participation in the transaction. Given that that the conflicted directors attended the meeting at which the arrangement was to be approved, and stated their comfort with the arrangement before leaving the meeting in advance of the vote, the court determined their recusal efforts were ineffective

Enforcement

Main Theme: Several enforcement actions have served to demonstrate the causes of action that state charity officials may apply to challenge corporate and governance actions of large nonprofit organizations.

For example, the tandem action by the New York State and District of Columbia Attorneys General (AG), seeking to dissolve the National Rifle Association (NRA) (and its affiliated foundation), represents one of the most significant enforcement actions against a not-for-profit corporation, and key officers, in the last ten years.[23]

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The core of the AGs' complaints is grounded in allegations of extensive violations of "fundamental" not-for-profit corporate law and fiduciary duties, as well as violations of corporate bylaws and policies, allegedly for the purpose of funding "lavish lifestyles" of NRA leaders. Particular allegations are that the audit committee operated consistent with a culture of noncompliance and disregard for internal controls.

The remedies sought in the complaints include the dissolution of the NRA, severe financial and other penalties against the key officers of the NRA, and return of the charitable funds allegedly improperly wasted on the NRA to the Foundation and a court order imposing changes to the Foundation to ensure it is operated independently and fulfills its charitable purposes.

The tandem action demonstrates the willingness of state charity officials to pursue enforcement of alleged violations of not-for-profit laws regulating corporate governance; laws that apply widely to major not-for-profit corporations such as hospitals and health systems.

As such, the AGs' complaints provide numerous valuable legal compliance lessons for hospitals and health systems

and their boards on how to maintain governance processes in a manner consistent with state law.

These lessons include strict adherence to vigorous conflicts of interest policies; a strong code of ethics for corporate officers and directors; meaningful authority for the general counsel and chief compliance officer; comprehensive internal controls over officer and director financial arrangements; board control in independent directors; an empowered and appropriately composed audit committee; and a corporate culture truly committed to the mission and to legal compliance.

Another notable enforcement action was taken by the Minnesota Attorney General to remove the trustees of a large charitable trust[24] based on allegations that the trustees seriously breached their fiduciary duty of loyalty by what the AG referred to as their "reckless" attempts to sell stock of the trust's primary asset (a large financial institution). The action was grounded in part in the AG's authority to regulate and supervise nonprofits and charitable trusts and is particularly notable to general counsel for its extensive discussion of the scope of that authority.

Conclusion

There has been an extraordinary number of important judicial and other developments in 2020 affecting corporate governance. These developments are highly relevant to organizationally sophisticated health care companies. They serve to underscore the fact that corporate governance continues to be a front-burner legal feasibility issue. They also provide a particularly useful basis from which chief legal officers can brief their internal clients on effective governance structures and protocols.

Endnotes

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